

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)	
)	
Federal-State Joint Board on)	CC Docket No. 96-45
Universal Service)	DA 98-2410

REPLY COMMENTS
OF THE
UNITED STATES TELEPHONE ASSOCIATION
ON THE
SECOND RECOMMENDED DECISION

The United States Telephone Association (USTA) hereby submits its reply comments to the comments submitted on the Second Recommended Decision of the Joint Board in the above-captioned proceeding (Recommended Decision).¹ In its comments, USTA found that the Joint Board Recommended Decision offered a modest proposal addressing issues related to the determination of high cost universal service support for non-rural carriers, but that it did not go far enough in addressing the important issue of making implicit support currently in access charges explicit. USTA advocated the adoption of its own Universal Service Plan for non-rural carriers that is comprehensive and thoroughly addresses the requirements in the Communications Act of 1934, as amended, (the Act)² for meaningful universal service reform.

After analyzing the other parties' comments filed in this proceeding, USTA continues to urge the Commission to adopt the USTA Plan. A significant number of parties commented on the need to make implicit charges explicit and the level of universal service support that is

¹63 Fed. Reg. 67837, Dec. 9, 1998.

²47 U.S.C. §§151 *et seq.*

appropriate. Also, a large number of parties addressed the appropriateness of the use of a forward-looking economic cost model and the reliance on such a model for determining distribution of universal service support amounts. USTA addresses those arguments herein.

I. Embedded implicit support needs to be made explicit by Commission action.

A major element of USTA's Plan is that embedded implicit support must be made explicit. A significant number of parties agreed with this policy.³ In fact, AT&T and MCI Worldcom both recognized that implicit access funds should be made explicit.⁴ However, both of these parties went on to make unfounded mischaracterizations of current access charges as justification for the "need" to reduce universal service subsidies. Specifically, AT&T and MCI Worldcom made allegations that access charges are inflated and exceed both the true cost of providing access and the subsidies needed for universal service.⁵ These parties then used their portrayal of access charges to impute that universal service subsidies must be reduced.⁶

These positions are clearly unfounded. Both these parties know full well the history of access charges and what they embody. The universal service costs recovered through access charges are fully justified and should continue to be recovered through an explicit universal service support mechanism. Incumbent local exchange carriers (ILECs) are required by the Commission's rules and federal/state decisions to allocate to the interstate jurisdiction costs that

³See Comments of BellSouth Corporation at 1-3; CompTel at 3-4; GTE Service Corporation at 4-7; Kentucky Public Service Commission; SBC Communications, Inc. at 1-4; Sprint Corporation at 6; Telecommunications Resellers Association at 4; and US West Communications, Inc. at 10.

⁴Comments of AT&T at i; MCI Worldcom at 4.

⁵Comments of AT&T at i; MCI Worldcom at 7.

⁶*Id.*

include the incremental costs of providing interstate services, including non-traffic sensitive and other common costs currently allocated to the federal level. This current allocation of costs to the interstate jurisdiction is the complex legacy of six decades of political decisions, adopted to further explicit policy objectives. Both AT&T and MCI participated in the access charge proceedings that resulted in these current policies. The long history of the decisions by which costs would be recovered through interstate access charges is set forth in an affidavit of former state and federal regulators, James M. Fischer, Albert P. Halprin, Henry M. Rivera and Marvin R. Weatherly, that was originally filed as part of USTA's comments in the Commission's Access Charge Reform proceeding.⁷ That affidavit is attached to these reply comments as Attachment A. It is critical to recognize that throughout this long and complex process, there has always been general agreement among federal and state regulators that the subject costs are real and legitimate expenses, which should be recovered in the aggregate from IEC customers in the interstate or intrastate jurisdictions. This history cannot be ignored, as AT&T and MCI Worldcom would have the Commission do so abruptly here.

AT&T and MCI Worldcom also launched into irrelevant and unwarranted attacks on the role of the ILEC's in access charges. AT&T erroneously claimed that IECs have been "gouging" interexchange customers and carriers by charging "vastly inflated" access charges.⁸ MCI Worldcom cited numbers for subscriber line charge, switched access charges and special access charges to claim that universal service revenues should be decreased.⁹ These allegations are

⁷Comments of USTA in CC Docket No. 96-262 on January 29, 1997, Attachment 2.

⁸Comments of AT&T at i.

⁹Comments of MCI Worldcom at 8-9.

unfounded and do not support the parties' positions. As has been demonstrated above, access charges are not inflated but rather embody the legitimate charges determined by federal and state regulators to be necessary and recoverable. Furthermore, MCI Worldcom's numbers are unsubstantiated.

AT&T also made the incredible statement that the Regional Bell Operating Companies and GTE should not receive universal service high cost fund payments because they have not opened their local markets to competition.¹⁰ First, the ILECs have opened their markets to competition since the passage of the 1996 Telecommunications Act. In fact, the ILECs have negotiated more than 5,400 interconnection agreements to open their local facilities to competitors. Consequently, Competitive Local Exchange Carriers (CLECs) now serve approximately 4 million access lines nationwide. Second, nothing in the provisions of the Act addressing universal service support, particularly Section 254,¹¹ conditions receipt by a local exchange carrier of universal service support upon the state of competition in a local market. Any eligible telecommunications carrier can receive support under that provision of the Act if it meets certain conditions, none of which relate to the state of competition in the particular market. Third, limiting universal service support eligibility would harm end-users that depend on such support in their communities solely to benefit the commercial interests of AT&T and MCI Worldcom. Finally, the Commission has already rejected the idea of limiting universal service support to those carriers that provide a Lifeline program. Specifically, the Commission stated that "We find that the unavailability of Lifeline to low-income consumers in these areas [states

¹⁰Comments of AT&T at 1 n.2.

¹¹47 U.S.C. §254.

that do not participate in the Lifeline program] runs counter to our duty to “make available, so far as possible, to all the people of the United States. . . a rapid, efficient Nationwide. . . wire and radio communication service.” The unavailability of Lifeline to many low-income consumers also conflicts with the statutory principles that access to telecommunications services should be extended to “[c]onsumers in all regions of the Nation, including low-income consumers.”¹²

It is abundantly clear that none of the revenues currently recovered through interstate access charges reflect excessive profits, waste, fraud or abuse. Instead, such revenues reflect recovery of costs assigned to the interstate jurisdiction for numerous public policy reasons.

II. A number of problems exist with the use of a forward-looking economic cost model to distribute high cost support.

AT&T and MCI Worldcom continued their unsubstantiated attack on the level of current implicit universal service support by advocating that such support should be determined on the basis of a forward-looking economic cost model. AT&T contended that reliance on embedded costs would “reward” LEC inefficiency, provide subsidies that could be used to thwart competition, and burden consumers.¹³ MCI Worldcom based its call for reduction in explicit universal service funding on an unsubstantiated analysis of current access charges pursuant to forward-looking economic costs.¹⁴

In its comments, USTA pointed out that the Recommended Decision acknowledged the fact that no model is complete and that the Joint Board could not make a final recommendation as to the method to be used to distribute high cost support. A substantial number of other parties

¹²*Universal Service Order*, 12 FCC Rcd 8776, at 8960 (1997).

¹³Comments of AT&T at 3-4.

¹⁴Comments of MCI Worldcom at 7-8.

voiced similar concerns.¹⁵ Based on the criticisms expressed by USTA and the Joint Board members, USTA recommended that the Commission should not rely on the Commission's forward-looking economic cost model in its current form to distribute high cost universal service support to carriers. As stated above, AT&T and MCI Worldcom's criticisms of the level of support are misplaced and inappropriate. Their attempts to utilize forward-looking costs to demonstrate their premise are likewise misplaced and are unsubstantiated. USTA continues to caution the Commission on the use of its current forward-looking economic cost model as a basis for distributing universal service support.

III. Conclusion

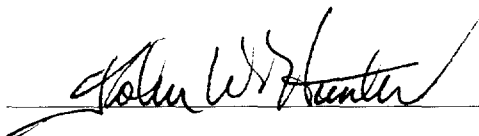
USTA's Universal Service Plan for non-rural carriers provides the Commission with a comprehensive plan by which to address the statutory requirements and policy objectives for providing high cost universal service support for non-rural carriers. As demonstrated herein, there is considerable support for the elements of the USTA Plan among commenting parties. The need to make implicit access charges explicit in universal service support is well-justified and

¹⁵See Comments of Arkansas, Kansas, Maine, Montana, New Hampshire, New Mexico, Vermont and West Virginia State Utility Commissions at 2-4; Bell Atlantic Telephone Companies at 5-6; BellSouth at 5-6; Colorado Public Utility Commission; District of Columbia Public Service Commission at 6-8; GTE at 25-26; Harris, Skrivan & Associates, LLC; Illinois Commerce Commission at 2-3; ITCs, Inc.; Maryland Public Service Commission, Connecticut Department of Public Utility Control, Delaware Public Service Commission, Illinois Commerce Commission, and Massachusetts Department of Telecommunications and Energy at 9-11, 14-15; Public Utilities Commission of Ohio; Puerto Rico Telephone Company at 4; Rural Telephone Coalition at 4-5; SBC at 1-4; Virgin Islands Telephone Corporation at 4-8; and Wyoming Public Service Commission at 2-4.

should be enacted, despite the attempts by AT&T and MCI Worldcom to limit the amount of support for their own advantage.

Respectfully submitted,

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January 13, 1999

ATTACHMENT A

ATTACHMENT 2

“IMPLICATIONS OF THE SEPARATIONS LEGACY FOR IMPLEMENTATION OF THE TELECOMMUNICATIONS ACT OF 1996”

**Affidavit of
James M. Fischer, Albert P. Halprin,
Henry M. Rivera and Marvin R. Weatherly**

**USTA Comments
CC Docket No. 96-262
January 29, 1997**

**Implications of the Separations Legacy for
Implementation of the
Telecommunications Act of 1996**

**Affidavit of James M. Fischer, Albert P. Halprin,
Henry M. Rivera and Marvin R. Weatherly**

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Implications of the Separations Legacy for
Implementation of the Telecommunications Act of 1996

Affidavit of James M. Fischer, Albert P. Halprin,
Henry M. Rivera, and Marvin R. Weatherly

I. **Synopsis**

The Federal Communications Commission's ("Commission" or "FCC") stated objective in initiating the CC Docket No. 96-262 access charge reform proceeding is to "end up with access charge rate structures that a competitive market for access services would produce."^{1/} Specifically, the Commission's goal is to foster competition in the telecommunications services market by ensuring that access charges "more closely reflect economic costs."^{2/} To that end, the Commission seeks comments on two possible approaches for determining interstate access charges on a going-forward basis. Under either approach, local exchange carriers' (LECs') revenues for interstate access services are likely - if not certain -- to be considerably lower than their current revenues for such services. The reason is simple: by deliberate regulatory design, current interstate access rates are set at levels necessary to recover not only the actual economic cost of providing access, but also a significant portion of the LECs' other costs, particularly non-traffic-sensitive network costs and other common costs.

^{1/} *Access Charge Reform*, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, CC Docket No. 96-262, FCC 96-488 (rel. Dec. 24, 1996) ("*Access Reform NPRM*" or "*Notice*"), at ¶ 13.

^{2/} *Id.* at ¶ 14.

Through a long series of decisions spanning six decades, federal and state regulators decided to allocate a large share of these costs to the interstate jurisdiction, in order to further explicit public policy objectives, notably the promotion of universal service and the maintenance of low local telephone service rates. These policy decisions have determined the jurisdictional allocation of billions and billions of dollars of LEC costs.^{3/} These policy decisions are given legal effect in the Commission's Part 36 rules governing the separation of the LECs' regulated expenses and investment between the state and federal jurisdictions.^{4/} Pursuant to the Commission's current Part 69 access charge rules, the costs allocated to the interstate jurisdiction are recovered through interstate access charges.^{5/} All segments of the telecommunications industry agree that the costs allocated to the interstate jurisdiction, and recovered through access rates, exceed the LECs' incremental cost of providing interstate access services. As noted in the *Access Reform NPRM*, the Commission, in adopting the Part 69 rules, "did not seek to eliminate implicit support flows, but in fact incorporated such flows into the Part 69 rate structure."^{6/}

If implemented, the access reforms proposed by the Commission will drive interstate access rates toward the incremental cost of providing these services. In other words, either of the alternative approaches to access charge reform discussed in the *Notice* would drive the

^{3/} As demonstrated in Attachment 13 to the U.S. Telephone Association's Comments in this proceeding, the amounts driven by policy decisions to the interstate jurisdiction are very substantial. As illustrated in the attachment, on various occasions, the Commission or Joint Board actively considered alternative bases for allocating certain costs that could have increased or decreased by billions of dollars the amount allocated to each jurisdiction.

^{4/} 47 C.F.R. § 36.

^{5/} 47 C.F.R. § 69.

^{6/} *Access Reform NPRM* at ¶ 6.

"implicit support flows" out of the interstate access rate structure. But the reforms will not alter the jurisdictional allocation of LECs' non-traffic sensitive costs and other common costs. Reform of the jurisdictional separations process has been deferred to a future proceeding.²⁷ Until and unless the separations rules are changed, the Commission must provide the LECs a way to recover the prudently incurred costs that they are required, by the separations rules, to allocate to the interstate level. In enacting the Telecommunications Act of 1996, Congress sought to promote competition, not to deny the LECs the legal right to recover prudently incurred costs. There is nothing inherently wrong with a policy-based division of LEC costs between the jurisdictions -- indeed, it is probably inevitable in a regulated environment. But regulators' obligation to provide for the recovery of these costs flows from their policy determinations. Constitutional precedents clearly protect the LECs from rules that would result in confiscatory rates.

To its credit, the Commission acknowledges and addresses this issue at some length in the *Access Reform NPRM*, and recognizes the legal and practical necessity of permitting the LECs to recover their prudent and reasonable actual costs of operation. Under either access reform option, the Commission has a legal and equitable obligation to provide a reasonable opportunity for the recovery of these costs.

²⁷ *Id.* at ¶ 6.

II. Introduction

For more than 60 years, there has been a fundamental debate between federal and state regulators regarding the relative proportion of local exchange carriers' non-traffic-sensitive network (*e.g.*, local loop costs) that should be recovered from interstate and intrastate services, respectively. The jurisdictional separations process, whereby LECs' network and related costs are allocated between the federal and state jurisdictions, has been the principal area where this debate has manifested itself. However, throughout the 60 years of debate, both federal and state regulators always recognized that LECs should be permitted an opportunity to recover their prudently-incurred embedded costs, in the aggregate, through the rates they charge for interstate or intrastate services. The costs allocated to the interstate jurisdiction determine the LECs' interstate revenue requirement, which they currently recover from the interstate access charges they collect from interexchange carriers. Likewise, the costs allocated to the intrastate jurisdiction are recovered from local telephone service rates, intrastate toll rates, and intrastate access rates.

The fundamental debate has revolved around the question of how to allocate primarily non-traffic-sensitive costs such as local loop plant.^{8/} Federal regulators have contended that the embedded costs of the local loop should be borne principally by the intrastate jurisdiction since they are related to the local loop which is required to provide local exchange service. State regulators, on the other hand, have argued that a larger share of local loop costs should

⁸ To illustrate the manner in which costs have been and are currently separated between the jurisdictions, this affidavit focuses primarily on non-traffic-sensitive costs. The same fundamental issue applies to all other common or joint costs assigned to the interstate jurisdiction.

be allocated to the interstate jurisdiction since the local loop is necessary to provide interstate interexchange service as well as intrastate interexchange service and local exchange service.

Over the years, the jurisdictional separations rules have been modified periodically, but one core feature has remained constant over six decades: these rules have been consistently designed to promote the public policy goal of encouraging universal service by keeping local exchange rates low while, at the same time, ensuring that LECs earn a reasonable return on their investment in the telephone network.

Although historically there has been a hot debate between federal and state regulators regarding the appropriate allocation of non-traffic-sensitive costs, there always remained a general agreement among these regulators that such costs are real and legitimate expenses which should be recovered, in the aggregate, from LEC customers in the interstate or intrastate jurisdictions. Under the current rules, 25 percent of certain regulated LEC costs, including primarily non-traffic-sensitive costs, are allocated to the federal jurisdiction,⁹ even though interstate traffic actually represents only about 15 percent of local loop usage.¹⁰ The importance of the recovery of these common non-traffic-sensitive costs is clear from the fact that over 95 percent of a LECs' total costs for regulated services are common or joint costs.¹¹

While the Part 61 LEC price cap rules, adopted in 1991, severed the direct link between the costs allocated to the interstate jurisdiction and the LECs' interstate access

⁹ *Amendment of Part 67*, Decision and Order, 96 FCC 2d 781 (1984)

¹⁰ See FCC Monitoring Report, CC Docket No. 80-286, Table 4.7 (rel. May 1996).

¹¹ FCC Access Reform Task Force. *Federal Perspectives on Access Charge Reform: A Staff Analysis* (April 30, 1993) at p. 65 ("FCC Task Force").

prices, the price caps were initialized on the basis of the LECs' jurisdictionally separated interstate costs, and therefore continue to reflect the support flows incorporated into the separations process.^{12/}

The legacy of the allocation of a significant portion of common loop costs to the interstate jurisdiction takes on heightened importance following the enactment of the Telecommunications Act of 1996 (the "1996 Act").^{13/} The new law has triggered a process that will result in significant changes to the policies and rules governing the pricing of LECs interstate services. The FCC has begun a comprehensive series of interrelated proceedings to implement the statute, including the instant proceeding on access charge reform, the Docket No. 96-45 Federal-State Joint Board on Universal Service,^{14/} and the CC Docket No. 96-98 interconnection proceeding.^{15/} Thus, in the next year, the FCC is likely to complete a major overhaul of both the access charges regime and its policies for promoting universal service.

As interpreted by the Commission, a major thrust of the 1996 Act is to promote the pricing of telecommunications services on the basis of the "incremental cost" incurred in providing them. A further objective is to eliminate "implicit" universal service subsidies and

¹² *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) and Erratum, 5 FCC Rcd 7664 (1990).

¹³ Telecommunications Act of 1996, Pub. L. No. 104-104, 100 Stat. 56, approved Feb. 8, 1996.

¹⁴ Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Notice of Proposed Rulemaking and Order Establishing Joint Board, FCC 96-93 (rel. Mar. 8, 1996).

¹⁵ *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Notice of Proposed Rulemaking, FCC 96-182 (rel. Apr. 19, 1996), 61 Fed. Reg. 18311; First Report and Order, FCC 96-325 (rel. Aug. 8, 1996) ("*Interconnection Order*").

replace them, where needed to ensure universal service, with explicit subsidies. In the local competition proceeding, the FCC advocated basing LEC interconnection rates on forward-looking long-run incremental costs.^{16/}

Likewise, the Commission's ultimate objective in this proceeding is to drive interstate access rates down to their forward-looking incremental costs. To that end, the Commission proposes two alternative approaches to access reform. The first alternative is a "market-based approach" that would "rely on potential and actual competition from new facilities-based providers and entrants purchasing unbundled [network] elements to drive prices for interstate access services toward economic costs."^{17/} The second alternative discussed in the *Notice* is a "more prescriptive approach" under which the Commission would "require incumbent LECs to move prices for interstate access in their service areas to more economically-efficient (*sic*) levels pursuant to rules adopted in [the access reform] proceeding."^{18/}

Either of these approaches, or a combination of the two, would inevitably result in a significant reduction in interstate access rates. The Commission recognizes this fact in the *Notice*, and to its credit, devotes considerable attention to the implications flowing from such

¹⁶ *Id.*

¹⁷ *Access Reform NPRM.* at ¶ 14. The Commission proposes to implement this market-based approach in two phases. In the first phase, upon a showing that rivals are able to enter its local market through interconnection, unbundled network elements, and resale, an incumbent LEC would be allowed to deaverage geographically its interstate access rates; offer volume and term discounts and contract-based tariffs for interstate access; and introduce new access services on a deregulated basis. In the second phase, an incumbent LEC's access services would be deregulated -- i.e., removed from price cap and tariff regulation -- when the LEC faces "substantial competition." *Id.* at ¶ 15.

¹⁸ *Id.* at ¶ 16.

a change. Specifically, the Commission acknowledges and addresses "the issues relating to the potential difference between the revenues that incumbent LECs generate from current interstate access charges and the revenues that revised access charges are likely to generate."^{19/} Moreover, the Commission notes that

Some of the difference between the incumbent LECs' interstate-allocated embedded costs and forward-looking costs may be traced to past regulatory practices. For example, interstate access rates may exceed forward-looking economic cost, and thus produce some difference, because of misallocation of costs to the interstate jurisdiction.^{20/}

The Commission also discusses the need for "alternative methods of recovery of that difference."^{21/}

It is important to stress that interstate access revenues will fall short of the level necessary to recover the embedded costs that are allocated to the interstate jurisdiction under all of the access reform options discussed in the *Access Reform NPRM*. The *Notice* appears to focus in particular on the revenue shortfall under the second reform option, the "prescriptive approach," acknowledging explicitly that "the Commission would be required to determine how much of the difference incumbent LECs should be given a reasonable opportunity to recover and the method for that recovery."^{22/} However, a revenue shortfall is also inevitable under the "market-based approach" or any combination of the two approaches. The basic premise of the market-based approach is that competition from other facilities-based carriers, and from carriers purchasing unbundled network elements from

¹⁹ *Access Reform NPRM* at ¶ 241.

²⁰ *Id.* at ¶ 249.

²¹ *Id.* at ¶ 241.

²² *Id.* at ¶ 143.

incumbent LECs at rates based on forward-looking long-run incremental costs, will force incumbent LECs to lower their access rates. This is undoubtedly correct. If competitors are able to offer access services by reselling network elements purchased from the incumbent LEC at incremental cost, the LEC will have no choice but to lower its own access rates to the same level in order to remain competitive in the access services market.

Access charges based on incremental costs would be considerably lower than current access charges. Current interstate access rates recover not only the incremental cost of providing access, but also costs, including non-traffic-sensitive network costs and other common costs, that regulators have allocated to the interstate level through the jurisdictional separations process. The difference between the incremental cost of providing access services, and the rates currently charged by the LECs, is not evidence of LEC inefficiency. Rather, it is the direct result of the historic policy decisions of the FCC and state regulators to recover a significant share of non-traffic-sensitive costs through interstate access rates. Moreover, the LECs are required under the FCC's separations rules to allocate these costs to the interstate jurisdiction, and are prohibited from recovering the amount allocated to the interstate jurisdiction through intrastate rates.

In the *Access Reform NPRM*, the Commission recognizes that the jurisdictional separations process results in "implicit support flows" from the interstate jurisdiction to the intrastate jurisdiction, and that these support flows currently are recovered in the LECs' interstate access rates.^{23/} The Commission also recognizes that access charge reforms that

²³ As the Commission noted in the *Access Reform NPRM*, "[i]n adopting the Part 69 rules, the Commission did not seek to eliminate implicit support flows, but in fact incorporated such flows into the Part 69 rate structure. Our Part 69 rules are designed to be consistent with our jurisdictional separations rules that govern the allocation of incumbent
(continued...)

result in access rates based on economic costs will generate access revenues for the LECs that are significantly below their current revenues.

So long as the LECs are required by the Commission's rules to allocate to the interstate jurisdiction costs in excess of the incremental costs of providing interstate services, including non-traffic-sensitive and other common costs currently allocated to the federal level, the LECs must have a means to recover these costs. In enacting the Telecommunications Act of 1996, Congress intended to promote competition, not to adopt a confiscatory law or remove the LECs' legal right to recover the prudently incurred costs that they are required to allocate to the federal jurisdiction.

The current allocation of costs to the interstate jurisdiction is the complex legacy of six decades of political decisions, adopted to further explicit policy objectives. This affidavit traces the origins of the current structure and summarizes the Commission's intimate involvement in the long history of the decisions about which costs would be recovered through interstate access charges. This historical review serves to highlight a simple point: if the Commission shifts to a new regime for setting access charges, such as either alternative proposed in the *Notice*, it must permit the LECs a reasonable opportunity to recover, through some other specific mechanism, the jurisdictionally interstate costs that are no longer recovered in interstate access rates. These costs are real; they have never been disallowed by any regulator in a prudency review. Absent significant policy changes that are not now under consideration or anticipated, the LECs will not be able to recover these costs in the intrastate jurisdiction.

²³ (...continued)

LECs' expenses and investment between the interstate and state jurisdictions." *Access Reform NPRM* at ¶ 6.

If the Commission now shifts to a new basis for calculating access charges that results in significant reductions in such charges, it cannot disclaim responsibility for the resulting gap between the LECs' interstate costs and revenues.^{24/} The Commission must determine how these costs will be recovered in the future.

The broader purpose of this affidavit is to demonstrate the Commission's obligation -- stemming from the legacy of the separations process, in which it was a major participant -- to address this issue. Several possible recovery mechanisms are discussed in the *Access Reform NPRM*, including permitting LECs to recover any costs found to constitute implicit subsidies through the new universal service regime to be adopted in CC Docket 96-45,^{25/} or establishing a transition recovery mechanism.

^{24/} In the *Notice* the Commission appears, commendably, to recognize that its longstanding, direct involvement in setting the jurisdictional separations rules, which drive current interstate access rates, precludes the Commission from disclaiming responsibility to provide for the recovery of costs it has required the LECs to allocate to the interstate jurisdiction. The Commission does not, and should not, pursue the same line of reasoning with respect to access charges that it followed in adopting a forward-looking, long-run incremental costing standard for pricing network elements in CC Docket No. 96-98. In that proceeding, the Commission disclaimed any responsibility for the fact that this standard would leave the LECs with billions of dollars in unrecoverable network costs, in part, based on the fact that it had never previously regulated the pricing of network elements.

^{25/} The Federal-State Joint Board on Universal Service did not recommend that costs assigned to the interstate jurisdiction, but not recovered in future access charges, be recovered in universal service support mechanisms. See *Federal-State Joint Board on "Universal Judgment Service*, Recommended Decision, CC Docket No. 96-45 (rel. Nov. 8, 1996). However, the Commission has not yet acted on the Joint Board's recommendations. In the *Access Reform NPRM*, the Commission recognized that "because of the role that access charges have played in funding and maintaining universal service, it is important to implement changes in the access charge system together with complementary charges in the universal service system." *Access Reform NPRM* at ¶ 40.

Regardless of the mechanisms chosen, the Commission has a legal obligation to provide LECs the opportunity to recover these costs if they are removed from existing access prices.

III. The Current Allocation of Costs to the Interstate Jurisdiction Is the Product of a Long History of Regulatory Compromises Designed to Further Specific Public Policy Goals

In theory, the jurisdictional separations process divides the costs of a LEC's network and operations between the federal and state jurisdictions based on cost causation principles. But in practice, such principles cannot be used to allocate the majority of telephone company costs, because they are non-traffic-sensitive. For instance, local loop plant, which is by far the largest category of non-traffic-sensitive costs, accounts for 41 percent of LECs' total unseparated costs. These costs are unrelated to the relative levels of interstate and intrastate usage. There are many possible methods for allocating such costs; the process used by the FCC and state regulators has been based on "informed judgment" -- a process of balancing various interests in order to further non-economic policy goals, including the goal of keeping local telephone service rates low. This has been achieved by sharing the recovery of non-traffic-sensitive costs and other common costs between the interstate and intrastate jurisdictions.

Significant vestiges of these historic practices continue to exist in the jurisdictional separations rules that apply currently to the LECs. For example, under the rules, 25 percent of loop plant costs currently are allocated to the interstate jurisdiction, accounting for more

than 40 percent of the LECs' total interstate costs.^{26/} The LECs currently recover these costs through their interstate access rates. The FCC phased in the 25 percent allocation of local loop costs to the interstate level over a seven year period between 1986 and 1993.^{27/} As discussed in greater detail below, this 25 percent gross allocator does not reflect the inherent share of loop costs attributable to interstate service. Instead, it represents a compromise among the federal and state regulators to promote their respective policy goals.

Thus, the separations process has provided a regulatory mechanism that allows the introduction of significant contribution flows (revenues exceeding the directly-identified costs for such services) among interstate and intrastate services. This has occurred since the inception of the process. In essence, the current arrangement is a compact among the FCC, state regulators, and the LEC industry, whereby the LECs are given the opportunity to recover through their interstate and intrastate rates the non-traffic-sensitive costs that are necessary to provide regulated telephone services.^{28/}

²⁶ *Amendment of Part 67*, Decision and Order, 96 FCC 2d 781 (1984); and LEC separations manuals.

²⁷ *Amendment of Part 67*, Decision and Order, 96 FCC 2d 781 (1984).

²⁸ *FCC Task Force* at 63. "The Separations procedures constitute a 'treaty' between the Commission and the state commissions that carefully balances a number of conflicting social objectives and competing interests."

A. Evolution of the Jurisdictional Separations Process: The Gradual Increase in the Allocation of LEC Costs to the Interstate Jurisdiction

The origins of the separations process antedate even the Communications Act of 1934, tracing back to the Supreme Court's 1930 decision in *Smith v. Illinois Bell Tel. Co.*^{29/} There, the Court found that the separation of a telephone company's costs between the interstate and intrastate jurisdictions was "essential to the appropriate recognition of the competent governmental authority in each field of regulation."^{30/}

Seventeen years later, in 1947, the first Separations Manual was adopted. The 1947 Manual required AT&T to separate costs and capital stock into intrastate and interstate categories, calculate the revenue requirements of the two parts of the separated capital stock, and divide the revenues received between Long Lines and the local telephone companies (both Bell and independent) in accordance with these revenue requirements.^{31/} Most important, all of the costs of the local exchange plant were divided between the interstate and intrastate jurisdictions on the basis of relative use measured by "subscriber line use" or "SLU."^{32/}

Over the next several years, regulators used the ambiguities inherent in the broad separations allocators to promote universal local telephone service by artificially maintaining high interstate toll rates, or at a minimum, by ensuring that such rates declined more slowly

^{29/} 282 U.S. 133 (1930).

^{30/} *Id.* at 145.

^{31/} Separations Manual, October 1947 cited in Temin, *The Fall of the Bell System: A Study in Pricing and Politics* (1987) at 24.

^{32/} SLU is defined as "the time the local plant was used for interstate calls divided by its total time in use." Temin at 23-24, n. 28.

than the decrease in underlying costs.^{33/} State regulators supported this practice because it kept their constituents' local telephone service rates low. The FCC supported these practices as well, because they allowed the agency to share political credit for advancing universal telephone service. Nor did AT&T resist these policies. Although AT&T's Long Lines operation was required, before divestiture, to charge higher rates for interstate toll service than otherwise, the company was not harmed because (1) rate of return regulation enabled it to recover additional revenues from any such jurisdictionally allocated costs, and (2) it faced no competitive pressure to price interstate services in proportion to their actual costs.

Advances in long distance technology rapidly reduced costs throughout the telecommunications industry, making it relatively easy for federal and state regulators to reach agreement on amendments to the jurisdictional separations process that shifted an ever greater share of LEC costs to the interstate jurisdiction. Rapidly declining costs made it possible to reduce interstate toll rates, even as the share of LEC costs assigned to the interstate level was increasing. Lower rates stimulated demand for interstate toll services, generating additional revenues and allowing further rate reductions. At the same time, the allocation of an ever increasing percentage of LEC costs to the interstate jurisdiction allowed local telephone service rates to remain artificially low.

On several occasions between the late 1940s and the 1970s, significant jurisdictional separations "treaties" were agreed to that resulted in increased allocations of LEC costs to the interstate jurisdiction. Figure 1 traces these revisions to the Separations Manual. These revisions forced AT&T to keep interstate toll rates high enough to recover the increasing

³³ The states generally follow a similar practice in pricing toll calls within their borders.

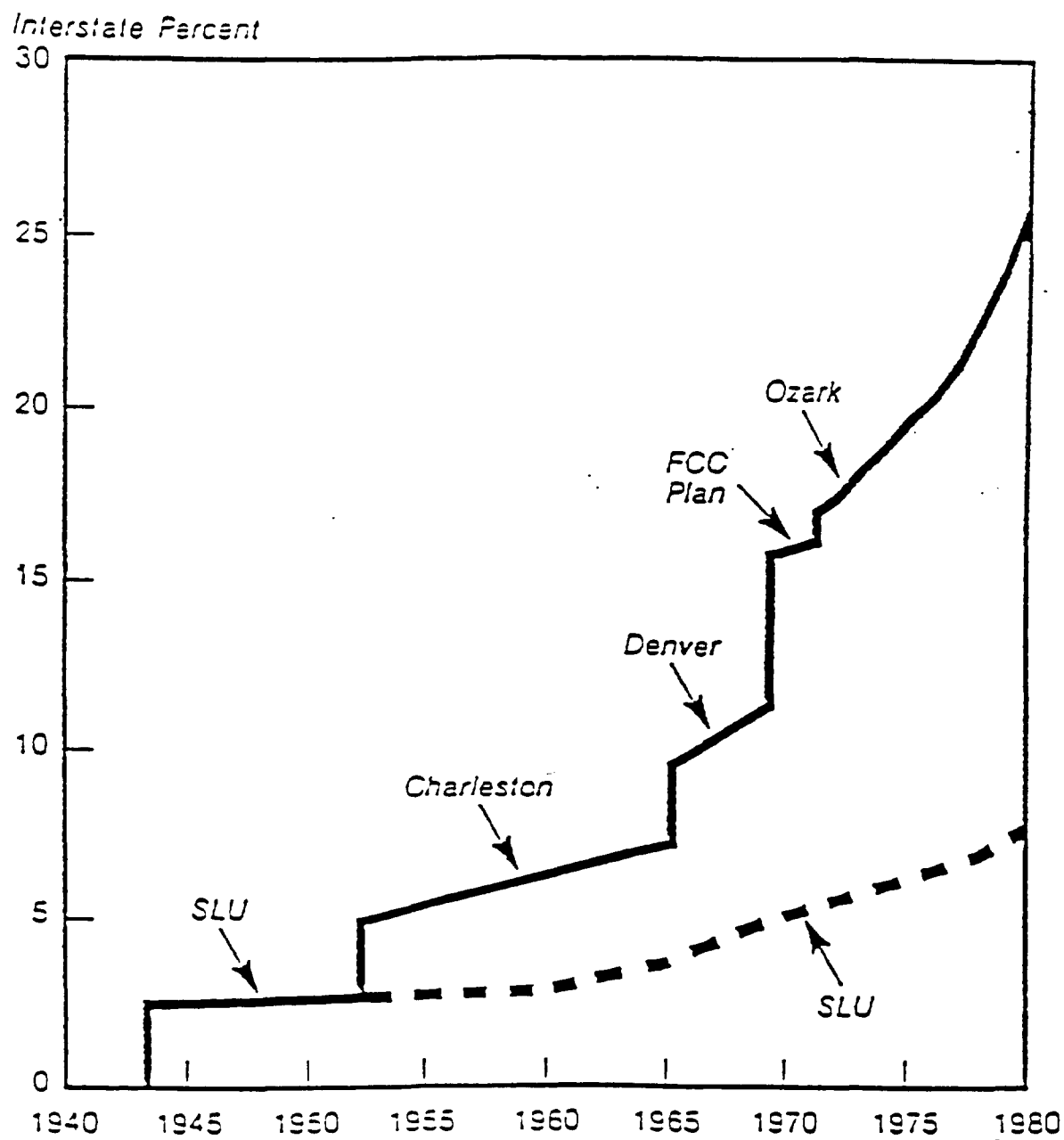


Figure 1.

(Source: P. Temin, *The Fall of the Bell System* 1987 at 26.)

share of non-traffic-sensitive costs allocated to the interstate level. While toll rates generally declined over this period, they were much higher than they would have been if regulators had not determined to use them to recover these additional costs. (Eventually, such government-mandated pricing created strong artificial economic incentives for competitive entry into interstate service and made such price/cost disparities increasingly untenable for AT&T.)

Perhaps the best example of the use of the separations process to promote universal local telephone service occurred with the FCC's implementation of the Ozark Plan in 1971.^{34/} This revision of the Separations Manual introduced the concept of the Subscriber Plant Factor ("SPF"). The starting point for computing the SPF was SLU (subscriber line use), the allocation standard established in the 1947 Separations Manual. But the SPF allocated an even higher proportion of local plant costs to the interstate jurisdiction than did SLU.^{35/} Indeed, under the Ozark Plan, the allocation of non-traffic-sensitive plant costs to the federal jurisdiction was approximately 3.3 times the proportion of interstate calling relative to intrastate calling.^{36/} The Commission approved the Ozark Plan in full

³⁴ *Prescription of Procedures for Separating and Allocating Plant Investment, Operating Expenses, Taxes, and Reserves Between the Intrastate and Interstate Operations of Telephone Companies, Recommended Report and Order*, 26 FCC 2d 248 (1970) ("*Separations Procedures Order*")

³⁵ The specific formula combines $SPF = 0.85 SLU + (2 SLU \times CSR)$ where CSR is the composite station rate (a ratio that combines measurements of average initial three minute station charges and average lengths of haul for interstate toll calls). *See Amendment of Part 67, Notice of Proposed Rulemaking and Order Establishing a Joint Board*, 78 FCC 2d 837, 841 (1980). Both the CSR and the 0.85 exchange cost factor were frozen for the industry at the adoption of the Ozark Plan in 1971. The 0.85 exchange cost factor was constant on an industry basis while the CSR was constant on a state basis.

³⁶ *See MCI v. FCC*, 750 F.2d 135, 137 (D.C. Cir. 1984).

knowledge of the fact that its implementation at the time would add \$130 million to the interstate revenue requirement.^{37/}

The ostensible justification for attributing a large share of non-traffic-sensitive costs to the interstate jurisdiction rested, in essence, on the fact that local calling typically was a flat-rate service, while interstate toll calling was charged by the minute.^{38/} It was viewed as unfair by state regulators to allocate non-traffic sensitive costs in simple proportion to actual minutes of local and interstate calling, since per-minute tariffing of interstate toll service was viewed as deterring subscribers from placing interstate calls, while flat-rate tariffing of local calls was viewed as encouraging such calls. The SPF was thought to compensate for the high level of local calling relative to interstate calling attributable to the rate structures for the two types of service. The net effect of the Ozark Plan was to cause AT&T to send about half of the revenues it collected for interstate toll service to its Bell operating company affiliates in the form of "settlement" payments.

For a time, this policy of attributing an ever-increasing share of the local telephone companies' non-traffic-sensitive and other common costs to the interstate jurisdiction was very successful. By imposing on interstate toll callers non-traffic-sensitive costs that reached approximately \$7 billion annually,^{39/} the transfer made a major contribution to the

³⁷ *Separations Procedures Order*, dissenting opinion of Commissioner Johnson, 26 FCC 2d at 259-264.

³⁸ 26 FCC 2d. at 251. *See also MCI v. FCC*, 750 F.2d 137 (D.C. Cir. 1984) at 138, n.3, citing *AT&T. Order*, 9 FCC 2d 30 (1967) at 102.

³⁹ Temin at 357, *citing* Temin & Peters, "Cross-Subsidization in Telephone Network," 21 Willamette Law Review 199-223 (Spring 1985).

55 percent decline in real terms of the price of basic local service between 1940 and 1980.^{40/} And that, in turn, helped raise the proportion of households subscribing to telephone service from 37 percent in 1940 to more than 93.9 percent by 1996.^{41/} By 1983, it was estimated that 40 percent of interstate revenues were being used to keep local rates at reasonable levels.^{42/} As described more thoroughly below, however, the advent of interstate toll competition eventually created marketplace pressures that made these arrangements untenable.

B. Adaptation of the Jurisdictional Separations Process to Competition in Interstate Toll Service

In the years following the adoption of the Ozark Plan in 1971, the telecommunications industry underwent several fundamental changes, including, perhaps most significantly, the authorization of interstate toll competition. In addition, AT&T's divestiture of the BOCs enhanced that competition and created its own ripple effects of change. The confluence of these changes created powerful incentives for AT&T to begin resisting the historic bases for the allocation of costs between the jurisdictions. Perhaps most obviously, the divestiture of the BOCs meant that the funds paid by AT&T for its use of local networks no longer

⁴⁰ Kahn & Shew, "Current Issues in Telecommunications Regulation: Pricing," 4 Yale J. on Reg. 191, 194-95 (1987) at 195, *citing* AT&T Economic Analysis Section, Relative Costs of Telephone Service 1940-1980 (1980).

⁴¹ *Id.* *Citing* U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the U.S. 495 (90th ed. 1969); and FCC, Telephone Subscribership in the United States (rel. Sept. 18, 1996).

⁴² Remarks of C. Brown, AT&T Annual Meeting, Atlanta, Georgia, April 20, 1983, *cited in* Termin at 307.

constituted an internal transfer that remained within the AT&T corporate family.^{43/} Even prior to divestiture, AT&T objected to the fact that its interstate toll competitors were able to avoid contributing toward the recovery of the local network costs assigned to the interstate jurisdiction.^{44/} Under the rules in effect at the time, these costs were recovered almost entirely through switched long distance service rates. AT&T's competitors avoided them by providing their services over private lines leased from AT&T. To add insult to AT&T's injury, this situation allowed its competitors to undercut AT&T's interstate toll rates.

Following divestiture, the new Bell operating companies (BOCs) also were adversely affected by the separations process. The process encouraged interexchange carriers and end users to engage in uneconomic bypass of the BOCs' facilities, in order to avoid having to pay the mandated access charges covering a substantial portion of the BOCs' non-traffic-sensitive costs.

To minimize these adverse effects, AT&T began to advocate the need for separations reform to better reflect the economic cost of regulated interstate services. AT&T argued that, principally as a result of the Ozark Plan's SPF factor, MTS/WATS usage was resulting in an assignment of non-traffic-sensitive costs to the interstate jurisdiction at a weighing of a nationwide average of 3.3 times the relative use of LEC networks for interstate services.⁴⁵

⁴³ AT&T's "settlement" payments to independent telephone companies gave them no significant incentive to appeal the plan either since these payments constituted less than 20% of all interstate settlement payments.

⁴⁴ 78 FCC 2d at 849.

⁴⁵ *Id.*

In June 1980, the FCC established a Federal-State Joint Board to examine the separations treatment of non-traffic-sensitive plant. The Commission adopted the Joint Board's recommended proposals with minor modifications in February 1982.^{46/} Recognizing that the federal share of local non-traffic-sensitive costs was significantly above the economic costs of the local loop, the FCC froze the total interstate contribution, SPF, at the average 1981 annual percentage levels, as an interim measure pending the development of comprehensive revisions in the separations procedures.^{47/} This marked the end of the "three-for-one" Ozark Plan. While the freeze imposed a cap on the percentage of non-traffic-sensitive costs allocated to the interstate jurisdiction, it allowed a growth in the absolute dollar allocation; thus as non-traffic-sensitive costs increased because of inflation or additional investment, the interstate share of those total costs would also increase.^{48/}

MCI challenged the SPF freeze in the U.S. Court of Appeals for the D.C. Circuit, arguing that the FCC should have reduced the interstate allocation instead of merely freezing it at a level almost three times above what relative usage would dictate. But MCI lost its appeal. The court ruled that the FCC's rationale for imposing the SPF freeze -- to preserve the Commission's ability to implement comprehensive separations revisions in a manner that would cause the least upheaval in the industry -- was reasonable.^{49/} The court went on to

⁴⁶ *Amendment of Part 67*, Decision and Order, 89 FCC 2d 1 (1982).

⁴⁷ *Id.* See, also, 47 C.F.R. § 67.124 (d) (1989)

⁴⁸ *Amendment of Part 67*, Decision and Order, 89 FCC 2d, (1982) at 13-14.

⁴⁹ 750 F.2d at 141.

acknowledge that "[c]ost allocation is not purely an economic issue, it necessarily involves policy choices that are not constitutionally prescribed."^{50/}

As part of a comprehensive reform of the separations process, the FCC ultimately reduced the allocation to the interstate jurisdiction caused by the SPF. In 1983, the FCC extended the SPF freeze until 1986, after which SPF was phased out over a seven year period. The transition to a "base factor apportionment," set at an unvarying 25 percent, began in 1987 and was completed in 1993.^{51/} The decision to set the allocation factor at 25 percent was an economically arbitrary, pure policy -driver decision. Indeed, the Commission never attempted to explain or justify the 25 percent allocation factor in economic terms; rather, the Commission justified it on the basis of its proximity to the then-current percentage of costs allocated to the interstate jurisdiction. This base factor apportionment continues to be used today, resulting in the allocation of 25 percent of non-traffic-sensitive loop costs to the interstate jurisdiction.

In 1978, the FCC established a Joint Board to determine "what reimbursement interstate services should make to local operating companies for the use of local plant" and "whether and how these charges can be equitably imposed on all interstate services."^{52/} An important first step proposed by the Joint Board was the introduction of limited flat-rated monthly charges assessed to all subscribers ("subscriber line charges" or "SLCs") to recover

⁵⁰ *Id.*

⁵¹ *Jurisdictional Separations Procedures*, Decision and Order, 49 Fed. Reg. 7934 (1984).

⁵² *MTS and WATS Market Structure*, Notice of Inquiry and Proposed Rulemaking, 67 FCC 2d 757,759 (1978).

some of the interstate non-traffic-sensitive costs that had been bundled into the per-minute rates for access service.

Implementation of the Joint Board's proposal was among the most controversial actions ever taken by the FCC. From the outset, the Commission recognized two things: that the introduction of the SLC required the cooperation and support of the state commission representatives on the Joint Board; and that given the intensity of the opposition to the SLC, there would be extreme political sensitivity to any further policy changes that could affect local rates. Indeed, decisionmakers often were more concerned with adopting proposals that created the least jurisdictional impact than with implementing the most economically efficient reforms. There was a widespread belief that it was not politically possible to move all, or even most, non-traffic-sensitive LEC costs to the intrastate jurisdiction, and that the transfer of any costs to that jurisdiction should be a gradual process.^{53/}

Joint Board members realized that if all non-traffic-sensitive costs were allocated to the intrastate jurisdiction, state regulators might consider raising intrastate toll rates in order to minimize the impact on local telephone service rates. Such a development would have harmed competition in the intrastate toll market and would have perpetuated economically inefficient pricing of long distance services, thus harming consumer welfare.

In the end, the Joint Board and the Commission adopted a pragmatic approach; in the interest of ensuring the success of the SLCs initiative, the FCC agreed to tolerate the continued allocation of a significant share of non-traffic-sensitive costs to the interstate

⁵³ The deliberate transitional nature of moving intrastate costs to the state jurisdiction was designed to prevent "rate shock" to residential customers of local service. "Rate shock" was typically understood to mean a rapid increase in the price of residential customers' local rates.

jurisdiction even though the FCC believed these costs rationally should have not all be recovered through intrastate level rates. For their part, legislators and state regulators were willing to tolerate the gradual introduction of the SLC on the basis of the FCC's firm commitment that the amount of the SLC would be passed through to consumers, dollar for dollar, in the form of interstate toll service rate reductions. In addition, state regulators negotiated agreements to introduce various programs designed to protect the universal service goals (*i.e.*, Lifeline credits and Link-Up America programs).

The decision to allocate 25 percent of all non-traffic-sensitive loop costs to the interstate jurisdiction is the most important example of how the jurisdictional separations rules are used to divide costs between the jurisdictions in furtherance of specific policy objectives.

The following are additional examples of similar separations practices involving the allocation of costs to the interstate jurisdiction. If interstate access rates are driven down to the incremental cost of providing access, the full amount of the costs discussed in these examples will no longer be recovered in such rates. Yet, at least until the separations process is reformed, these costs will continue to be allocated to the interstate jurisdiction. Regardless of the rules the Commission ultimately adopts to govern interstate access service pricing in the future, it must provide a means for the LECs to recover these costs. The Commission cannot -- and as a legal matter may not -- penalize the LECs for its policy decisions reflected in these examples.

C. Current Separations Practices Driven by Policy Considerations

1. Marketing Expenses

Prior to 1987, LEC marketing expenses were allocated between the jurisdictions on the basis of local and toll revenues. In revising the Separations Manual in 1987, the Joint Board recommended, and the FCC adopted, new procedures that allocated marketing expenses on the basis of revenues excluding access revenues.^{54/}

In their petitions for reconsideration of that order, several LECs argued that a significant shift (\$475 million) in revenue requirement to the state jurisdiction would result from the exclusion of access charges in contravention of the Joint Board's goals in that proceeding. On reconsideration, the FCC decided to include access revenues in the allocation factor for marketing expenses as an interim measure pending the outcome of a further inquiry by the Joint Board.^{55/} The net effect of this change was to allocate about 26 percent of the LECs' total marketing expenses to the interstate jurisdiction.^{56/} This is a significant allocator, inasmuch as the LECs spend far less on marketing of interstate access service, relative to their interstate revenues, than they spend on marketing their intrastate services. Moreover, as the history of this issue demonstrates, this allocation was chosen precisely because of concerns that the previously approved allocation would have resulted in

⁵⁴ *MTS and WATS Market Structure*, Report and Order, 2 FCC Rcd. 2639 (1987).

⁵⁵ *MTS and WATS Market Structure*, Memorandum Opinion and Order on Reconsideration, 2 FCC Rcd. 5349 at para. 2426 (1987).

⁵⁶ *FCC Task Force* at 67.

a shift of costs to the intrastate jurisdiction. Whatever the merits of the original decision, it was overturned for this "pure policy" reason.

2. **Billing Inquiry Services**

In 1984, the New York Public Service Commission alerted the FCC and the Joint Board that, under the separations rules then in effect, AT&T's assumption of billing inquiry services previously provided by the LECs would cause a sudden and substantial reassignment of Account 645 costs to the intrastate jurisdiction.

Prior to that time, LECs performed the billing and collection, including billing inquiry services, for both local telephone service and long distance toll calling carried over AT&T's network. This reassignment was caused by the fact that under these rules, the level of Account 645 costs assigned to the interstate jurisdiction was largely a product of the customer contact factor.^{57/} However, responding to end user billing inquiries involved a very small portion of local commercial work time.^{58/} Moreover, the interstate customer contact factor had been developed from a formula based on relative revenues rather than the use of actual accounts or samples of contacts.^{59/} Thus, AT&T's provision of its own billing inquiry service would reduce the number of local commercial office contacts related to interstate toll messages, thereby lowering the interstate cost assignment, without producing

^{57/} The customer contact factor is the relative number of business office contacts relating to state toll and interstate toll messages and was used as the allocation factor under the separations rules in effect at that time.

^{58/} See *MTS and WATS Market Structure*, Memorandum Opinion and Order, 1 FCC Rcd. 1216 at para. 3 (1986).

^{59/} See *MTS and WATS Market Structure*, 60 Fed. Reg. 2d 1345 at para. 12 (1986).

an offsetting reduction in total local commercial office costs. The jurisdictional shift was far in excess of the costs that LECs would save by discontinuing their billing inquiry service and underscored the jurisdictional allocation of costs that had been produced by the then existing separations procedures.^{60/} The Joint Board and the FCC acknowledged that excessive Account 645 costs had been allocated to the interstate jurisdiction, but in light of the potentially abrupt jurisdictional shift, decided that, as an interim measure until permanent measures for the allocation of Account 645 were adopted, the interstate allocation of these costs should be frozen and then gradually phased down over a twelve month period to approximately one-half of the preexisting level. The affected BOCs were ordered to adjust their access charge tariffs to reflect these changes. These tariffs were later allowed to go into effect over the objections by AT&T that the BOCs had allegedly failed (1) to reduce their billing and collection rates to reflect correctly the transfer of certain costs from preexisting billing and collection rate elements to the new interim traffic-sensitive rate element, and (2) to comply with the phased down Account 645 and related costs assigned to the interstate jurisdiction.^{61/}

As a consequence, although acknowledging that Account 645 allocated a disproportionate amount of costs to the inflated interstate jurisdiction, the FCC and Joint

^{60/} The Joint Board; MTS and WATS Market Structure, Mimeo No. 3400 (rel. March 25, 1985), 50 Fed. Reg. 14729 (April 15, 1985); and the FCC MTS and WATS Market Structure, 50 Fed. Reg. 26204 (June 25, 1985), *recon.*; 60 Fed. Reg. 2d 1345 (adopting the Joint Board's recommended interim separations procedures); *MTS and WATS Market Structure*, Decision and Order, FCC No. 865 (rel. January 7, 1986); 51 Fed. Reg. 3176 (January 24, 1986), *recon.*; 1 FCC Rcd. 1216 (adopting the Joint Board's reasoning for such procedures).

^{61/} *New England Telephone and Telegraph Company, et al.*, Order, 1986 FCC LEXIS 2932 (rel. August 5, 1986).

Board perpetuated it for at least a year thereafter. Even when the FCC eventually adopted permanent changes to the allocation of Account 645 expenses,^{62/} it anticipated that these new separations procedures would decrease, but not eliminate, the inflated interstate allocation of Account 645.^{63/} Even in the midst of the separation reforms, the Joint Board and the FCC were very much aware of, and always discussed and considered, the potentially adverse policy ramifications of moving too many dollars to the intrastate jurisdiction.

3. Local Dial Switching Equipment

For purely pragmatic reasons, the FCC and Joint Board were extremely reluctant to include the costs of subscriber plant in the subscriber line charge. A classic example of that reluctance was the separations and access charge treatment of Local Dial Switching Equipment.^{64/}

^{62/} See, 60 Fed. Reg. 2d at n. 22. The rules became effective on January 1, 1987. They were originally due to become effective on June 1, 1986. 51 Fed. Reg. 3176. In 1986, the FCC preemptively detariffed the LECs' provision of billing and collection for unaffiliated interexchange carriers. In 1987, the FCC decided to continue to apply the jurisdictional separations process to billing and collection service costs to identify investment and expenses that are properly attributable to intrastate activity. It anticipated that the detariffing of billing and collection would not shift costs between the state and interstate jurisdictions, but that it would merely remove some interstate costs from the regulated arena. Detariffing of Billing and Collection, 102 FCC 2d 1150 at para. 48 (1986).

^{63/} See, 60 Fed. Reg. 2d at para. 21. Retention of the Local Subsidy.

^{64/} Examples of Local Dial Switching Equipment include basic switching train, toll connecting trunk equipment, inter-local trunks, tandem trunks, terminating senders used for toll completing, toll completing trains, call reverting equipment, weather and time of day service equipment, concentration equipment, and switching equipment at electronic-analog or digital remote line locations. See, *Amendment of Part 67, Recommended Decision and Order*, 2 FCC Rcd. 2551 at para. 3 (1987).

Under the former Part 67 separations procedures, carriers were required to divide their investment in the former Category 6 Central Office Equipment (COE), Local Dial Switching Equipment, into non-traffic-sensitive and traffic-sensitive components. The non-traffic-sensitive component was allocated on the basis of the frozen SPF, whereas the traffic-sensitive component was allocated on the basis of dial equipment minutes (DEM), which included toll weighing factors (TWFs).^{65/} Under the former Part 69 rules, carriers were required to apportion costs between three end office elements: Line Termination, Local Switching, and Intercept.

Local Switching was divided into two sub-elements: Local Switching 1 ("LS1") and Local Switching 2 ("LS2"). The former Line Termination and Local Switching elements reflected the classification of the former Category 6 COE, Local Dial Switching Equipment, into traffic-sensitive and non-traffic-sensitive portions for jurisdictional separations purposes. The differences in the former LS1 and LS2 sub-elements of the Local Switching element reflected the TWFs applied to toll minutes for the purpose of allocating the traffic-sensitive portion of the former Category 6 COE.

Effective January 1, 1988, the FCC revised the Separations Manual, pursuant to Joint Board recommendations, to consolidate the former Category 6 COE, Local Dial Switching, with other switching categories to form a new category, COE Category 3, Local Switching Equipment.^{66/} This new category was allocated between the jurisdictions on the basis of

^{65/} TWFs were intended to reflect the then higher cost of usage of the switch by toll calls, which are trunk side connections, rather than local calls, which are line side connections.

^{66/} The former COE categories included: Category 4, Automatic Message Recording Equipment; Category 5, Other Toll Dial Switching Equipment; and Category 7, Special Services Switching Equipment.

DEM. In other words, the FCC eliminated the traffic-sensitive/non-traffic-sensitive distinction applicable to Local Switching Equipment, allocating on a relative usage basis as though such costs were all traffic-sensitive, which they were not. Most LECs supported this change as a warranted simplification of the separations process.

The FCC believed that because digital switching equipment was presumably comprised mainly of traffic-sensitive components, a flat allocation factor would be inappropriate.^{67/} The FCC also eliminated the use of TWFs and the LS1 discount on the assumption that with the use of modern switches, use of the switch for toll calls is no longer more costly than for local calls.^{68/}

The LECs were also required to phase in the DEM allocation factor over the 1988-1992 period in order to forestall substantial shifts in costs from the interstate jurisdiction to the state jurisdiction which were anticipated if the new procedures were implemented on an immediate basis.^{69/} While eliminating the traffic-sensitive/non-traffic-sensitive distinction and allocating all Local Switching Equipment as if it were traffic-sensitive has simplified the interstate treatment of such equipment, such changes have also created an uneconomic recovery mechanism. (by recovering non-traffic-sensitive costs on a traffic-sensitive basis). It was believed that the benefits of simplicity were more important than economic efficiency.

⁶⁷ 3 FCC Rcd. 5518 at para. 49.

⁶⁸ See, e.g., 4 FCC Rcd. 765 at para. 7 (1988).

⁶⁹ On the access charge side, the FCC combined Line Termination, LS1 and LS2, into a single access element that was assessed on the basis of unweighted access minutes. The FCC also established a transition mechanism to eliminate the rate differential between the LS1 and LS2 sub-elements.

Moreover, the combining of COE categories and the five year phase-in perpetuated what the FCC considered to be an overallocation to the interstate jurisdiction. Over time, it has become increasingly clear that the non-traffic-sensitive portion of Local Switching Equipment is greater than was publicly predicted by the FCC and the Joint Board. Indeed, technical advances in local dial switching have increased the amount of non-traffic-sensitive switching costs currently being recovered in Local Switching rates. Recent studies performed within NYNEX using switch vendor-provided information and considering other usage and size parameters provided by NYNEX traffic engineers, reflect that the average percentage non-traffic-sensitive costs range from 6 percent for analog electronic switching systems to an average of 51 percent for the most modern digital systems. Whereas the determination of which size switch to install is clearly a traffic-sensitive decision,^{70/} a local switch exhibits many of the same cost factors as non-traffic-sensitive local loop;^{71/} once it is installed, the switch incurs virtually no additional costs based on the traffic it handles, within reasonable ranges.

Moreover, the non-traffic-sensitive portion of such equipment is used to support the local loop, not the provision of carrier access services. The only reason such costs were excluded from the subscriber line charge was because, at that time, the FCC was in the midst of a controversy of attempting to recover, for the first time, any costs directly from end user subscribers. To have proposed increasing the subscriber line charge to include recovery of

^{70/} "Even if virtually all switching costs become fixed when the switch is installed, the decision to install a large switch rather than a small switch or to install five switches rather than four is affected by the anticipated traffic volume." 3 FCC Rcd. 5518 at para. 47.

^{71/} The non-traffic-sensitive portion of the local switch is a function of the number of loops it supports, not the volume of traffic.

local switching could have jeopardized the entire subscriber line charge effort because of fears that customers would become overburdened with interstate costs, which ultimately could harm universal service. While the political decision to exclude local switching costs from the subscriber line charge was arguably justifiable at the time the decision was made, this issue warrants reexamination by a Joint Board. In a competitive environment, attempting to recover the costs of subscriber plant through loadings may not be sustainable in the future.

4. Interexchange Circuit Equipment and Cable and Wire Investment

Part 36.126 of the Commission's rules currently requires that LECs' interexchange trunk investment be assigned to the message joint, interstate private line, and intrastate private line subcategories, and that these costs be allocated among these subcategories on the basis of "termination counts."^{72/} Similarly, Part 36.156(a) of the Commission's rules requires that Category 3 interexchange cable and wire costs be assigned to the above subcategories, and that these costs be allocated based on the average cost per equivalent telephone circuit kilometer.^{73/} Part 36.156(b) requires that the cost of cable and wire facilities attributable to this category be assigned directly where feasible.^{74/}

It is possible, in the course of developing basic cost studies, to directly identify the interexchange circuit equipment, cable, and wire costs associated with each subcategory,

⁷² 47 C.F.R. § 36.126.

⁷³ 47 C.F.R. § 36.156(a).

⁷⁴ 47 C.F.R. § 36.156(b).

except message joint. Direct assignment of these costs would be appropriate, since all categories of interexchange cable and wire investment and interexchange circuit equipment (except message joint) are jurisdictionally pure. A core principle of the separations process is that direct assignment, where feasible, is superior to the use of broad allocators. If direct assignment were used for these costs, it would be necessary to continue using traffic usage factors to determine the jurisdictional allocation within the message joint subcategory.

Moreover, if the majority of interexchange circuit equipment cable and wire facilities costs were allocated directly, with only a small portion of costs allocated based on traffic usage factors, this would result in a significantly lower allocation of such costs to the interstate jurisdiction than under the current rules. Specifically, for all LECs, the amount of interexchange circuit equipment costs allocated to the interstate jurisdiction would be approximately \$197 million lower than under the current methodology. Likewise, an analysis of certain LECs' cable and wire costs, extrapolated to the entire industry, suggests that approximately \$23.5 million less of the LECs' combined interexchange cable and wire costs would be allocated to the interstate jurisdiction. These figures further support the proposition that the costs currently allocated to the interstate level, and recovered through interstate rates, reflect policy decisions and not necessarily the LECs' actual costs of providing interstate services.

IV. Conclusion

For decades, the Commission, in conjunction with state regulators, has established policies deliberately designed to recover the LECs' non-traffic-sensitive network costs from both the interstate and intrastate jurisdictions. Even when significant changes were made to

the separations process in the 1980s, the FCC and the Joint Board were well aware that large amounts of interstate non-traffic-sensitive and other costs would continue to exist at the end of that set of reforms. These changes in the separations process were part of a deliberate attempt by decisionmakers to advance various political and policy goals rather than merely to foster economically efficient pricing:

[Any characterization of separations as] a small, technical process of no particular importance . . . is a totally untenable position. The rapid growth of separations charges could not have escaped the attention of even the densest regulator. Everyone connected with telecommunications . . . knew that local telephone service was being supported more and more by revenues from interstate traffic. Anyone who thought about the amount of money involved must have understood that this was hardly the unintended fallout of a jurisdictional decision in 1930. It was instead the result of an ongoing political process^{75/}

This history holds important lessons in the context of the Telecommunications Act of 1996 and the Commission's access charge reform initiative. In particular, it explains why current access charges are set well above the pure economic cost of providing access services. These rates reflect a whole series of deliberate policy decisions to move certain costs to the interstate jurisdiction or leave them there when it was no longer logical or economically efficient to do so.

The purpose of these decisions primarily was to reduce upward pressure on local telephone service rates and thereby maintain universal service goals. These goals were largely accomplished by the policies of the FCC and Joint Board in the separations process. The allocation of a significant portion of LECs' non-traffic-sensitive costs and other joint and common costs to the interstate jurisdiction, and the requirement that these costs be recovered

⁷⁵ Temin at 358.

through interstate access charges, currently are legal requirements imposed by the government, in furtherance of its policy objectives.^{26/}

In the *Access Reform NPRM*, the Commission takes an important step -- but only a first step -- towards addressing the cost recovery issue, by clearly acknowledging the legacy of separations policy decisions and by addressing some of the implications for access charge reform. For the first time in a Commission order, the agency recognizes the legal and practical necessity of permitting LECs to recover their prudent and reasonable actual costs of operation. At the same time, however, the Commission fails fully to appreciate the implications of proposals in the *Notice*. To the extent the FCC decides to adopt rules that will drive access rates down to the incremental cost of providing access, it must recognize and resolve the cost recovery issues raised by its own past policies. And that is exactly what would happen under either of the access reform options discussed in the *Notice*, or any combination of the two options. It would occur directly under the prescriptive approach, but just as inevitably under the market-based approach. Since other carriers would be free to purchase the network elements necessary for interstate access from the LECs, at the elements' incremental cost, the LECs would have no choice but to lower their access rates. That would create a revenue shortfall. Recovering the shortfall by raising local rates or rates for other intrastate services is not an option, since it is prohibited under the separations rules.

²⁶ There is nothing inherently wrong with a policy-based division of plant cost between the jurisdictions. In a regulated environment, any allocation of non-traffic-sensitive plant is certain to reflect, in large measure, policy views. There is, of course, no greater economic rationale for a SLU-based division of such plant cost than for a division based on a flat allocator chosen by the regulator.

In fact, the most important and relevant policy determination is the division between the portion of non-traffic-sensitive cost charge end-users and the portion charged to others -- a determination that is made separately at both the federal and state levels.

Thus, unless a new mechanism were established to recover the shortfall, the LECs' only other option would be to recover as much of the shortfall as possible by increasing their rates for interstate services that are least subject to competition. Such pricing distortions would simply perpetuate the inefficiencies the Commission is seeking to eliminate.

Accordingly, the FCC must establish a mechanism or mechanisms for the LECs to recover the difference between the costs they are required to allocate to the interstate jurisdiction and the revenues they will generate under the new access pricing rules. To fail to provide for their recovery would raise significant legal issues and violate the basic social compact under which the telecommunications industry has operated and related to its regulators for over 60 years. A fundamental tenet of that compact has been that if the government decides by regulatory fiat to shift to the interstate jurisdictions costs a LEC actually incurs in providing intrastate services, the LECs will be able to recover these costs at the interstate level.

The legal and constitutional principles governing the cost recovery issue are clear. The rates set by regulators for a LEC's services must be sufficient to provide a reasonable return to investors.⁷⁷ To satisfy this standard, rates set by regulators must provide "enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stocks."⁷⁸ Further, the

⁷⁷ See, e.g. *Bluefield Water Works and Improvement Co. v. PSC of West Virginia*, 262 U.S. 679 (1923); *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n of Missouri*, 262 U.S. 276 (1923); *Smyth v. Ames*, 169 U.S. 466, 546 (1898); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989); *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168 (D.C. Cir. 1987).

⁷⁸ See *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) at 603.

return that is the end result of the rate-setting process "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."^{79/} Rates that are not sufficient to yield a reasonable return for the regulated entity are "unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."^{80/} The Commission has flexibility in determining how the costs assigned to the interstate jurisdiction will be recovered. That is, it can and does determine which services and rates will be used to recover what share of the interstate costs. But the above-cited precedents establish clearly that the combined revenues from the LECs' interstate services must be sufficient to recover the LEC costs assigned to the interstate jurisdiction.

If the Commission adopts new rules that result in incremental cost-based rates (either directly through prescription of such rates or indirectly through adoption of the market-based approach), the LECs' interstate access rates no longer will be sufficient to recover the costs assigned to the interstate jurisdiction. The legal precedents governing cost recovery instruct the Commission, in such circumstances, to provide some other means to recover the difference.^{81/}

⁷⁹ *Id.*; see also *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168 (D.C. Cir. 1987) at 1176.

⁸⁰ See *Bluefield Water Works*, 262 U.S. at 690; see also *Duquesne Light*, 488 U.S.

⁸¹ If future interstate access rates are insufficient to recover the costs assigned to the interstate jurisdiction, the unrecovered costs will effectively be stranded. Some advocates have argued, incorrectly, that *Duquesne Light Co. v. Barasch* (488 U.S. 299 [1989]) and other Supreme Court cases stand for the principle that a utility's "losses due to competition are not recoverable." See, e.g. K. Rose, *An Economic And Legal Perspective On Electric Utility Transition Costs* (Nat'l Reg. Research Inst., Jul. 1996) ("NRRI Electric Transition Costs Paper") at 59-61. Even if this interpretation were correct -- which it is not -- it clearly
(continued...)

It is also important to note that reform of the separations process is unlikely to resolve the problem of how to provide for the recovery of prudently incurred LEC costs. To the extent that any states adopts pricing rules comparable to those the Commission proposed to use in pricing of network elements -- i.e., based on incremental costs -- it will not be possible for LECs in those states to recover any costs that may be reallocated (through reform of the separations process) to the intrastate jurisdiction. Just as incremental cost pricing of network elements at the interstate level would force the LECs to set their interstate access rates at incremental cost levels, incremental cost-based pricing of network elements at the intrastate level would force the LECs to do likewise with respect to intrastate services. The LEC must compete with carriers that purchase network elements from the LEC. The prices it charges for its services will tend to be forced toward the prices it is required to charge competitors for the network elements used to provide a given service.

Indeed, through numerous Commission and state regulatory proceedings, the LECs are being required to price an increasing number of services at their incremental costs. Service after service is being foreclosed as a means for the LECs to recover the difference between incremental costs and the actual costs of operation that they prudently incur. Yet the LECs have the legal right to recover these reasonable costs. What is required is a carefully coordinated approach to ensure the recovery of these costs in a rational and

⁸¹ (...continued)

does not apply to the cost recovery issue discussed in this affidavit. The losses LECs would incur if the Commission drives access rates toward the incremental cost of providing interstate access would not be due to competition, but rather to regulation. Unless the Commission provides a mechanism to recover the difference between the LECs' access revenues under the rules and their costs assigned to the interstate jurisdiction, an unconstitutional confiscation of LEC property will result.

economically efficient manner that furthers the Commission's -- and Congress' -- pro-competitive goals for the telecommunications sector. At the interstate level, that means that the Commission must adopt a coherent set of rules governing the recovery of costs allocated to the federal jurisdiction. In particular, this requires the establishment of a mechanism to recover the difference between the revenues the LECs will generate from interstate access services, following access charge reform, and their prudently incurred costs assigned to the interstate level.

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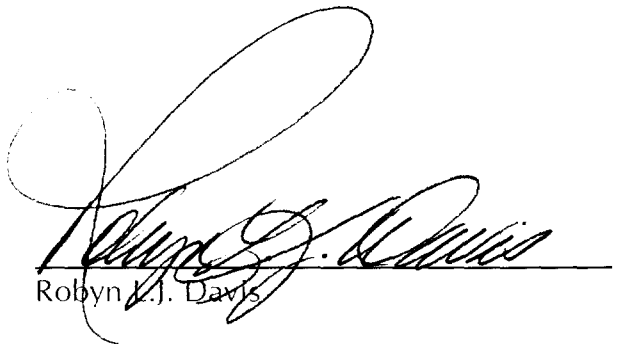
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